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SUBJECT: JAMAICA'S CENTRAL BANK WARNS OF PRICE INSTABILITY

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SUMMARY

¶1. (SBU) Spiraling inflation is complicating planning for Jamaican policy makers. Inflation for the first three months of 2008 is running at 5.2 percent and the central bank is warning that prices could jump by a further six percent in the next three months. This would bring prices for the first half of 2008 to over 11 percent, surpassing the original 11 percent target for the entire year. Inflation continues to be driven by local and international commodities prices as well as policy-based decisions. The foreign exchange market remains stable, with the local currency depreciating by only 0.7 percent. Rising prices have forced the Central Bank to revise the inflation target to between 11.5 and 14.5 percent. Even if international commodities prices were to decline significantly during the second half of the year (which is unlikely), it is improbable that inflation will fall within the new target range. End summary.

INFLATION A MOVING TARGET

¶2. (SBU) Spiraling inflation, fuelled by rising food and oil prices, is complicating planning for Jamaican policy makers. Only a month ago, Minister of Finance and the Public Service Audley Shaw projected inflation of between nine and ten percent in 2008, a marked slowdown from the 16.8 percent registered in 2007. However, speaking at a Quarterly Monetary Policy Report (QMPR) Meeting on May 7, one of Shaw's chief advisors and Governor of the Central Bank Derrick Latibeaudierre revised the annual inflation target to between 11.5 and 14.5 percent. He also projected inflation of six percent for April to June 2008. Although this forecast is at best optimistic, it means inflation for the first half of 2008 could be 11.2 percent, which is close to the 11.5 bottom range of his projection for the entire year. When asked at the meeting why an upward revision was made in such a short period of time, Latibeaudierre blamed the change on unforeseen movement in international commodities prices. He added, "The underlying assumptions have changed since April, with the prices of rice and corn rising well beyond our expectations."

RECORD INFLATION

¶3. (SBU) Despite a government subsidy on basic food items, inflation for the first three months of 2008 was 5.2 percent, bringing prices for the fiscal year ending March 2008 to 19.9 percent. Inflation for January to March 2008 was also above the projected 3.5 percent

as well as the average of 1.2 percent for the last five March quarters. Cost-push inflation continues to provide the major impetus for price hikes. Food, which accounted for over 50 percent of the increase, remained the single most dominant influence on inflation during the March quarter. Food- related inflation continued to emanate from both domestic and international agricultural commodities, with the prices of rice and corn rising by 35.9 and 28 percent, respectively. Wheat prices, an input for flour, baked products and animal feeds, jumped by a further 18.3 percent. Upward pressure on prices has also been caused by rising energy costs for producers being passed through to consumers.

RISK OF PRICE INCREASES PERSISTS

¶4. (SBU) As the country grapples with record inflation, there are factors that may cause price increases to persist. Chief among these are the many policy-based decisions taken in the last two months. The revised tax structure on motor vehicles and higher user fees announced during the recent budget debate are bound to feed inflation in upcoming months. Factor in the 28 percent hike in water rates and the 25 percent price increase granted to taxi operators and the risk of higher prices escalates. Worse yet is the continuing rise of international commodities prices, with oil prices surpassing USD 125 per barrel, well above the USD 95 on which the budget was predicated. Other cost push influences are set to emanate from international grain prices, with rice, corn, and wheat flour registering record prices. But demand-pull factors are also expected to come from relatively robust salary increases in the public sector as well as the massive USD 60.5 million payout to workers at the Jamaica Public Service. These pay raises are expected to set the stage for higher wage increases in the private

sector, providing further impetus for inflation and inflationary expectations.

FOREIGN EXCHANGE MARKET STABLE

¶5. (SBU) Although prices have risen significantly, there was relative stability in the foreign exchange market as evidenced by the marginal (0.7 percent) depreciation in the local currency. The depreciation of the Jamaican dollar occurred in the month of January 2008 because of high levels of liquidity and heightened inflationary expectations, which caused some investors to increase their demand for US denominated assets. To address the instability, the Central Bank issued open market instruments to investors while at the same time increasing the interest rates. The result of these monetary policy actions was an appreciation in the exchange rate during February and March 2008. The stability was further buffeted by the widening interest rate differential between Jamaican and U.S. dollar based assets, as well as uncertainty in the international financial markets, which increased the attractiveness of Jamaican dollar assets (Note: During the quarter the Fed Reserve continued its policy of reducing rates. End note.) As a result, the country's Net International Reserves (NIR) rose to USD 2.1 billion, USD 205.7 million more than at the end of December 2007.

BUT BOP POSITION TENOUS

¶6. (SBU) Rising prices could also set the stage for Balance of Payments (BOP) instability. Imports are already up by 22.4 percent during January 2008. Oil imports of USD 206.4 million accounted for 32 percent of the total import bill. The country's oil bill could soar to over USD 3 billion if oil remains above USD 125 per barrel. The central bank projected oil prices of USD 95 for 2008, which would equate to an oil bill of about USD 2.5 billion. Although tourism arrivals and remittances are up, Latibeaudiere was quick to point out that nothing in the BOP can offset a USD 500 million increase in the oil bill. Jamaica does not have the capacity to immediately benefit from exchange rate competitiveness or rising agricultural prices in the short term, thus any further increase in oil prices could force the country to draw down on its stock of NIR. Therefore, unless Jamaica's domestic demand for oil moderates, it

may have to rely on its NIR, which could lead to renewed instability in the foreign exchange market. Latibeaudiere addressed this eventuality saying, "macroeconomic stability is critical and with Jamaica being a price taker, no tool at the disposal of the Central Bank will be taken off the table," suggesting that further hikes in interest rates could not be ruled out to address instability in the foreign exchange market.

TOURISM AND REMITTANCES RESILIENT

¶7. (SBU) Tourist arrivals to Jamaica increased by 7.7 percent during January to March 2008. Since 70 percent of visitors to the island come from the U.S., it does not appear that the slowdown in the U.S. economy is hindering tourism. Some speculate that tourism numbers will fall if the economic situation in the U.S. worsens, but historical evidence suggests no correlation between a slowing U.S. economy and visitor arrivals or remittances to Jamaica. In fact, the island remains one of the most price competitive destinations in the region as the local currency has been sliding along with the weakening U.S. dollar. There also has been a diversion of some U.S. visitors from more expensive destinations in Europe due to the stronger Euro. Tourists from Europe and Canada also are finding Jamaica a bargain, given their stronger currencies and increased purchasing power. Spanish investors have added over 10,000 rooms in the last four years and have been marketing these travel packages to European tourists.

¶8. SBU) Remittances from Jamaicans living abroad, particularly those in the U.S., have remained buoyant in the first quarter, jumping by 11 percent to USD 540 million. (Note: Most remittances to Jamaica are used for core necessities such as food, rent, and school fees. The continued resilience of this flow of funds in light of an economic downturn is not surprising, given its importance to family members residing on the island. End note.)

COMMENT

¶9. (SBU) Local inflation will continue its upward climb on the back of buoyant international and local commodities prices. This, coupled with a series of recent administrative price increases

announced by the Jamaican government, could send inflation for the first half of the year to well above ten percent. There is no indication that international commodity prices will fall significantly in the second half of the year, so the GOJ will likely be forced to further revise its inflation target at the next QMPR meeting in August. It appears that the Central Bank is using the new optimistic target range for inflation as a way to manage inflationary expectations. As more information becomes available, the targets will likely be revised again.

¶10. (SBU) Increased international prices, particularly for oil, will lead to higher imports, and could by extension impair the country's ability to finance its import bill. If oil remains above the USD 125 per barrel level, the Central bank could well be forced to draw down on its stock of NIR to finance imports. Any significant drawdown in the NIR could lead to increased speculation, resulting in increased demand for U.S. denominated assets and a concomitant weakening in the local currency. In this event, the central bank would be left with no choice but to use the only tool at its disposal, interest rates, to temper demand pressures. But any upswing in interest rates will affect the fiscal authorities' ability to service the nation's gargantuan debt. Rising interest rates also would be a blow to the government's economic growth target of three percent for 2008. End Comment.
JOHNSON